Professor Modigliani on price controls: the baleful influence of the perfectly competitive model

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During the depths of the Great Depression, 1,028 economists signed a letter and sent it to President Herbert Hoover, counselling him against signing into law the Smoot-Hawley tariff. In the modern era, 562 practitioners of the dismal science sent an open letter to President William Clinton, warning him of the perils of price controls embodied in his health-care plan (Armen *et al.*, 1994).

Both of these events are readily understandable, in view of the strong consensus among economists on these issues. For example, Frey *et al.* (1984) compiled American economists' responses to 27 different public policy issues, and found the second greatest agreement with regard to the destructive effects of tariffs and import quotas, and the fourth greatest agreement as to the harmfulness of price controls. Block and Walker (1988) replicated this survey for Canadian economists, and found the greatest agreement with regard to the destructive effects of tariffs and import quotas, and the second greatest agreement as to the harmfulness of price controls. In the Frey *et al.* (1984) study, the highest consensus was achieved in opposition to rent control; for Block and Walker (1988), the same statement: "A ceiling on rents reduces the quantity and quality of housing available" achieved the third highest consensus of all 27 statements.

It must be the rare economist, after all, who favours government interference with price signals, the life-blood of our economy. There is little doubt that both sets of economists expected that their efforts would help promote the economic welfare of the nation. The present author was pleased to be one of the signatories to the 1994 letter, and admits to hoping that the project would actually do some good. Was this a selfless act, contrary to the findings of the Public Choice School (Buchanan and Tullock, 1971; Buchanan *et al.*, 1980)? In part, perhaps. But it must not be forgotten that there are benefits of such public exercises, the externalities of which can be internalized: prestige, self-promotion, etc.

But not all economists agreed. Modigliani (1994) chided all the signatories of Armen *et al.* (1994) for failing to preface their remarks with a phrase indicating, in effect, that opposition to price controls only makes sense under the assumption of (near) perfectly competitive conditions. He warned all economists of "cloaking our personal preferences under the mantle of science,

International Journal of Social Economics, Vol. 22 No. 5, 1995, pp. 27-30. MCB University Press, 0306-8293

without making certain that we are in fact relying on basic scientific principles and not on idiosyncratic value judgments".

I object. Although this controversy first arose in the Op Ed pages of a newspaper, it is important enough to deserve the more careful consideration that only a scholarly journal can supply. I claim not only that the critics of price controls are not guilty of such rank politicization, but also that Modigliani himself, unfortunately, is.

Which basic economic axiom allows us to draw the conclusion that price controls do not enhance economic welfare? It is from the insight that voluntary commercial interaction necessarily benefits both parties in the *ex ante* or anticipations sense. That is to say, the reason buyer and seller agree to a contractual arrangement is because each expects to gain thereby. (There is no necessity for this, but the presumption – particularly in the case of repeat business – is that both parties improve their economic situations in the *ex post* sense as well; that is, they are happy with the deal in retrospect as well as prospect.)

Price controls, by their very nature, prohibit some trades from occurring which would otherwise have taken place. Thus, they reduce the welfare of those who would have benefited from them. In addition, free market prices prevent shortages and surpluses (e.g. housing shortages under rent controls and labour surpluses or unemployment with minimum wage laws) and provide valuable information as to relative scarcities. In the words of Armen *et al.* (1994): "In the 1970s, government tried to regulate the price of a simple homogeneous product, gasoline. The result was a social and economic disaster. People were forced to waste hours waiting in lines to purchase gasoline. Long waits for surgery and other medical care will have far more serious consequences."

It is perhaps only a slight exaggeration to say that, had it not been for the Sears-Roebuck catalogue, and other free market price information provided to the world by an open society such as ours, the economy of the USSR would not have lasted 70 months, let alone 70 years. The last thing we need in the USA is the economic arteriosclerosis of price controls.

Bad as our own price controls on oil products were, they pale into insignificance compared with the pre-1989 Soviet practices in this regard. There, people would think nothing of a wait of several hours in a queue to buy practically anything: bread, chickens, toilet paper. As the Open Letter states, the last thing any well-intended person should want is to apply such a system to our medical care industry.

But what of the perfectly competitive model of the socialist economist, Lerner (1934; 1943/1994) and numerous others that Professor Modigliani, the Nobel prize winner of 1985, cites in his *Wall Street Journal* missive (1994)? It is here that he engages in idiosyncratic value judgements of his own.

In this world view, unless there are numerous buyers and sellers of homogeneous products under conditions of near full information (a condition that rarely or virtually never occurs in the real world), monopolists, or oligopolists or "imperfect competitors" will raise prices and reduce quantities offered for sale. Further, this constitutes a misallocation of resources, compared with what would prevail under the glorious conditions of "perfect competition". Therefore, price controls, "suitably chosen", says Modigliani (1994), can lower prices, raise quantities, and more efficiently allocate resources. But if there is one thing we have learned from F.A. Hayek, another Nobel Prize winner (in 1973), it is that bureaucrats cannot "suitably choose" their way out of a paper bag. Price controls are thus a recipe for poor central planning at best (see Hayek, 1948/1975; Hoppe, 1993).

Worse, there is no objective criterion on the basis of which we can assert that concentrated industries misallocate resources while non-concentrated "competitive" ones do not. Modigliani (1994) claims that the results of the "suitably chosen" price controls he favours "could well be an improvement of the general welfare, except of course that of the producers who would have to give up the extra profits they were able to reap by their artificial restriction of output". But all such assertions rest on impermissible interpersonal comparisons of utility, whereby it is claimed that consumer welfare somehow trumps producer welfare. If this is not an "idiosyncratic value judgement", nothing is. Moreover, there is simply no warrant for maintaining that the amounts offered for sale by large corporations are "artificial".

A far better way of looking at competition is in terms of rivalry and free entry. As long as government plays no favourites with subsidies and taxation, as long as it does not preclude new competitors from entering an industry, there is competition. The derogatory "monopoly" should not be applied to companies such as Alcoa or IBM, even when they accounted for 100 per cent of their relevant markets. They competed fairly and fully. The boxing ring, after all, is a very competitive place, even though its too "firm" concentration ratio is 100 per cent (see Armstrong, 1982). Contrary to Modigliani, the charge of monopoly should instead be reserved for such as the post office and the tax industry, where government mismanagement and restrictions on competition are the order of the day.

Why resort to the utility industry – a mad burst of analogy-mongering? This is the reddest of red herrings. Instead, had Modigliani looked at the medical labour market itself, he would have seen an industry that even he might be sorely tempted to label "perfectly competitive". After all, there are thousands and thousands of doctors, all of whom, apart from sub-specialties, provide services which are reasonably interchangeable. Of course, there is that little matter of the monopoly powers wielded by the American Medical Association. However, as shown by yet another winner of the Nobel Prize in economics (Friedman, 1962; Hamowy, 1984), this is the result, not of market competition, but of a government grant of exclusive licensing privileges. It could best be dealt with by substituting a system of market certification.

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